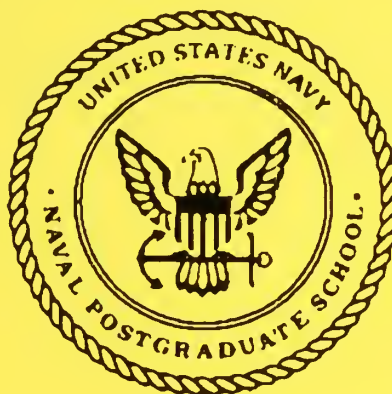


NAVAL POSTGRADUATE SCHOOL MONTEREY, CALIFORNIA



THE ASEAN FREE TRADE AGREEMENT: PRECIPITATING CAUSES AND FUTURE CONSEQUENCES

BY

STEPHEN G. BROOKS

DECEMBER 1993

Approved for public release; distribution is unlimited.

Prepared for:
Chief of Naval Operations
Washington, D. C. 20350

FedDocs
D 208.14/2
NPS-NS-93-004

20710
8/14/2 NPS-93-004

**NAVAL POSTGRADUATE SCHOOL
MONTEREY, CALIFORNIA**

Rear Admiral Thomas A. Mercer
Superintendent

Harrison Shull
Provost

This report was prepared in conjunction with research conducted for the Chief of Naval Operations and funded by the Naval Postgraduate School.

Reproduction of all or part of this report is authorized.

This report was written by:

(UNCLASSIFIED)
SECURITY CLASSIFICATION OF THIS PAGE

REPORT DOCUMENTATION PAGE

1a. REPORT SECURITY CLASSIFICATION UNCLASSIFIED			1b. RESTRICTIVE MARKINGS	
2a. SECURITY CLASSIFICATION AUTHORITY			3. DISTRIBUTION/AVAILABILITY OF REPORT APPROVED FOR PUBLIC RELEASE; DISTRIBUTION IS ULIMITED.	
2b. DECLASSIFICATION/DOWNGRADING SCHEDULE				
4. PERFORMING ORGANIZATION REPORT NUMBER(S) NPS-NS-93-004			5. MONITORING ORGANIZATION REPORT NUMBER(S)	
6a. NAME OF PERFORMING ORGANIZATION Naval Postgraduate School		6b. OFFICE SYMBOL (If Applicable) NS	7a. NAME OF MONITORING ORGANIZATION	
6c. ADDRESS (city, state, and ZIP code) Monterey, Ca 93943-5100			7b. ADDRESS (city, state, and ZIP code)	
8a. NAME OF FUNDING/SPONSORING ORGANIZATION OP-60		8b. OFFICE SYMBOL (If Applicable)	9. PROCUREMENT INSTRUMENT IDENTIFICATION NUMBER	
8c. ADDRESS (city, state, and ZIP code) Chief of Naval Operations Washington, DC 20350			10. SOURCE OF FUNDING NUMBERS	
			PROGRAM ELEMENT NO.	PROJECT NO.
11. TITLE (Include Security Classification) THE ASEAN FREE TRADE AGREEMENT: PRECIPITATING CAUSES AND FUTURE CONSEQUENCES				
12. PERSONAL AUTHOR(S) STEPHEN G. BROOKS				
13a. TYPE OF REPORT FINAL REPORT		13b. TIME COVERED MAR 1991 to JAN 1993	14. DATE OF REPORT (year, month, day) DECEMBER 1993	15. PAGE COUNT 22
16. SUPPLEMENTARY NOTATION				
17. COSATI CODES			18. SUBJECT TERMS (continue on reverse if necessary and identify by block number)	
FIELD	GROUP	SUBGROUP		
19. ABSTRACT (Continue on reverse if necessary and identify by block number) <p>This paper examines 1) the transformations in the international economy that led to the ASEAN (Association of Southeast Asian Nations) Free Trade Agreement and 2) the factors working in favor and against the agreement's implementation.</p> <p>The underlying motivation for AFTA is examined in terms of being a reaction to the rise of the European Community and the North American Free Trade Agreement, which led to fears of reduced foreign investment, trade diversion, diminished bargaining power in negotiations, and lower international competitiveness.</p> <p>The implementation of AFTA is discussed as being constrained by a number of factors, including regional security tensions, product exclusions, long lead time, uneven levels of development, insufficient coordination of external policy, as well as lack of treatment of NTBs, subsidies and government procurement practices.</p>				
20. DISTRIBUTION/AVAILABILITY OF ABSTRACT (X) UNCLASSIFIED/UNLIMITED () SAME AS RPT () DTIC USERS			21. ABSTRACT SECURITY CLASSIFICATION Unclassified	
22a. NAME OF RESPONSIBLE INDIVIDUAL STEPHEN G. BROOKS			22b. TELEPHONE (Include Area Code) (408) 656-2521	22c. OFFICE SYMBOL NS

Introduction

Ideas for economic cooperation have been regularly advanced throughout ASEAN's history, but none of these proposals achieved any results. The promise of higher quality, lower cost products never outweighed the political pain that was caused by industries that would be hurt by trade liberalization. It was only because of the substantial threat posed by the North American Free Trade Area (NAFTA) and the European Community (EC) that the impetus for ASEAN to proceed with regional liberalization finally became strong enough. On 28 January, 1992 the leaders of the Association of Southeast Asian Nations (ASEAN) signed a treaty creating the ASEAN Free Trade Area (AFTA). AFTA aggregates the economies of Singapore, Thailand, Indonesia, Philippines, Malaysia and Brunei, which combined represent more than 330 million people and a GNP of over \$300 billion. AFTA aims to reduce tariffs to between 0 and 5% over the next fifteen years on all products currently traded in the region, with the exceptions of unprocessed agricultural goods and services. In total, the products included in the agreement account for 87% of ASEAN's total trade.

Tariffs will be reduced according to the Common Effective Preferential Tariff (CEPT) agreement. Beginning on January 1, 1993, tariffs on most CEPT products will be reduced to a maximum of 20% over the next five to eight years. After tariffs have been reduced to 20% or lower, over the next seven years they will be further reduced to 0-5% by the year 2008. In addition, fifteen sectors of products were placed on an accelerated schedule of tariff reduction under the CEPT.¹ Tariffs on these products will be reduced below 5% within seven years if rates are presently less than 20%, and within 10 years if tariffs are currently above 20%. Other quantitative restrictions, such as quotas and non-tariff barriers, are also scheduled to be eliminated under the agreement.

AFTA is a significant agreement for ASEAN. I argue that the underlying motivation for AFTA can be traced back to broader transformations in the international

¹The fifteen sectors are: vegetable oils, cement, chemicals, pharmaceuticals, fertilizer, rubber products, leather products, pulp, textiles, ceramic and glass products, gems and jewelry, copper cathodes, electronics, wooden and rattan furniture.

economic system, specifically the rise of economic regionalism as an organizing feature in world trade. After examining the forces that led to the agreement, the factors working in favor and against the agreement's implementation will be reviewed.

Explaining the Emergence of AFTA

The rise of economic blocs in Europe and North America produced a sea-change in the attitudes of ASEAN countries towards regional integration. As recently as 1987, the leaders of ASEAN considered and then rejected a proposal to form a free trade area. Had the international economic system remained unaltered from 1987, it is highly unlikely that ASEAN would have decided to pursue regional economic cooperation. The reactive nature of ASEAN was highlighted by the region's leaders, as Prime Minister Goh of Singapore contended that "if we don't synergize our strengths, ASEAN will risk missing the boat. We will be stranded as we watch others sail by."² Prime Minister Mahathir of Malaysia noted how the "creation of powerful economic groupings to advance regional interests have become a reality of international economic life." President Suharto of Indonesia warned that economic regionalism "will have negative effects on the developing countries if it is followed by the establishment of groups among countries and eventually leads to closed and protectionist economic blocs."

The leaders of ASEAN felt threatened by the EC and NAFTA for five principal reasons: 1) they were concerned about trade diversion, 2) multi-lateral trade organizations, notably the GATT, were weak at this time, 3) they feared foreign investment would be diverted from ASEAN, 4) they thought they would be unable to negotiate with such powerful groupings, 5) they were apprehensive that their international competitiveness would be reduced. Each of these factors is detailed below.

²Asian Wall Street Journal, January 28, 1992, p. 1

Trade Diversion

An obvious fear among ASEAN is that the EC and NAFTA will become increasingly insular and will set up strict barriers to the import of goods from outside each economic bloc. As Table 1 indicates, ASEAN countries are particularly worried about being shut out of Europe and North American markets because their development strategies are based largely around exports to these two markets.

TABLE 1: DESTINATION OF EXPORTS OF ASEAN COUNTRIES

	EXPORTE					ASEAN
	Indonesia	Malaysia	Philip- pines	Singapore	Thailand	
Importer	1988	1988	1988	1988	1987	
US	16.0%	17.4%	29.6%	21.4%	16.7%	19.7%
Japan	41.7%	16.9%	16.2%	7.7%	13.4%	17.1%
EC	11.2%	14.5%	14.2%	11.6%	19.9%	13.3%

Source: Calculated using data from United Nations. Commodity Trade Statistics.

The EC has already established a common external tariff, and NAFTA will not have one, so ASEAN does not need to fear that its goods will face higher tariffs in these two economic blocs. Nevertheless, ASEAN exports to both Europe and North America could be reduced as a result of trade diversion, where trade shifts to within the bloc, replacing goods that were formerly imported from outside the bloc. Trade diversion occurs because there are no restrictions on intra-bloc trade while goods from outside the bloc still face tariffs and other trade barriers.

The greatest fear of ASEAN countries is that their exports into Canada and the United States will be replaced by goods from Mexico, since it has very similar factor

endowments to Southeast Asia.³ Trade diversion will, of course, occur in Europe as well, since Portugal, Greece and to a lesser extent Spain, could play the same role as Mexico will in NAFTA, that of being a low cost producer of commodity goods. The wages in these countries are not nearly as low as in Mexico, however, so ASEAN has less to worry about trade diversion with regards to Europe than North America.

In addition to trade diversion, ASEAN is also worried that the coalescing of the EC and NAFTA will lead to an increase in non-tariff barriers. Technical and environmental standards, even if they are not designed to discriminate against producers from outside the bloc, will likely improve the competitiveness of companies within the bloc. ASEAN companies could be hard pressed if they are required to substantially alter their production processes in order to comply with new regional standards.

ASEAN countries are also afraid of the psychological effects of integration. Lim Boon Heng, Singapore's senior minister of state for trade and industry, stated that "although both the single European market and NAFTA are claimed to be non-protectionistic, they will cause their businessmen to look inward."⁴ Because of increased regional consciousness, it is likely that companies, as well as consumers, will become accustomed to searching for suppliers within the bloc to supply their demands.

While ASEAN exports to Europe and North America may be reduced by trade diversion, the creation of AFTA could have the same effect on goods that ASEAN is currently importing. Loss of employment in export sectors to the EC and North America could be offset by an increase in goods produced within AFTA. As Table 2 on page 12 indicates, only 15.5% of the goods that are included in the agreement are currently imported from other members of ASEAN. As a result of AFTA, a substantial percentage of the \$76 billion of goods that are currently imported from outside ASEAN might eventually be produced within the group, either by ASEAN companies or MNCs from the rest of the world. As a result, there could be a substantial shift from

³The Financial Post [Bangkok], February 10, 1993, p. 13.

⁴Asian Wall Street Journal, August 14, 1992

goods produced by foreign workers to goods that are produced by workers from one of the countries in the bloc.

The leaders of ASEAN hope that trade creation within the region will offset any losses of export markets in Europe and North America. Trade creation is extremely beneficial, since the increased trade will be in products that are made by either new or augmented industries within the bloc, which therefore means more employment. There has been a tremendous amount of trade creation within the EC over the years, a phenomenon which will likely be duplicated within NAFTA. The phenomenon of trade creation in the other blocs is a process that ASEAN wishes to emulate through the creation of its own trade bloc.

Multi-lateral Trade Organizations

The need for ASEAN to respond to the ascendance of NAFTA and the EC was particularly acute because of the weakness of multilateral trade organizations at this time. Most notably, ASEAN's faith in GATT was shattered because of the impasse in the Uruguay round in December 1990. Asia has benefited probably more than any other region of the world as a result of freer trade promoted through GATT. The export-led development strategies of the ASEAN countries have only been possible because of the relatively free flow of goods guaranteed by GATT. From ASEAN's perspective, as well as the whole of Asia, it appeared that the vast bulk of the developed world was abandoning its commitment to world-wide free trade in favor of regional free trade. Far from offsetting the negative effects of economic regionalism, GATT appeared to ASEAN to be yet another casualty of this trend.

A second organization ASEAN was unable to rely upon to protect its economic interests was the Asia-Pacific Economic Cooperation (APEC). Formed in 1991, APEC is a grouping of the United States, Canada, Japan, China, South Korea, Singapore, Philippines, Thailand, Malaysia, Brunei, Taiwan, Hong Kong, Indonesia, Australia and New Zealand. APEC's purpose is to increase interdependence between Pacific countries, discuss ways of promoting regional and world trade, and increase economic growth in the region. APEC has ten different working groups: trade promotion,

expansion of investment and technology transfers, human resource development, regional energy cooperation, marine resource conservation, telecommunications, transportation, data, tourism and fisheries.⁵

While the goals and actions of APEC are extremely beneficial to the promotion of regional trade, the members of ASEAN did not see APEC as an adequate response to the rise of trade blocs in Europe and North America. With or without APEC, members of ASEAN felt that there would be a diversion of investment and trade from Asia to these two new blocs. APEC would not be able to do anything to arrest the reduction in international competitiveness of ASEAN exports as a result of the formation of these two blocs. While APEC would be helpful when the group adopted a common position when negotiating with the EC or countries outside of APEC, within APEC itself the bargaining power of the ASEAN states would still be weak vis-a-vis the United States or Japan. Thus, APEC was seen as a helpful but inadequate response to the new global economic environment confronting ASEAN.

It was as a result of the breakdown of GATT negotiations, the rise of trade blocs in Europe and North America, the inability of small Asian countries to negotiate with such large economic entities as the EC, and the current inadequacy of APEC, that on December 7, 1990, Prime Minister Mahathir of Malaysia proposed the East Asian Economic Grouping (EAEG). Mahathir envisioned the EAEG as a trade bloc which would include Japan, China, South Korea, Singapore, Thailand, Philippines, Malaysia, Brunei, Taiwan, Hong Kong and Indonesia. Mahathir maintained that if North America and Europe turned inwards and put up protectionist walls against Asian goods, that it would be necessary to find other markets for Asian goods. Mahathir saw Asia itself as the most logical replacement of the European and North American markets. Mahathir felt that the formation of a regional grouping would substantially boost trade within the region, possibly to the point of offsetting any loss of markets elsewhere in the world. Mahathir also felt that such a powerful and diversified economic grouping would have a strong bargaining position vis-à-vis the EC and

⁵James Baker, "America in Asia", Foreign Affairs: Winter 1991/92, p. 6

NAFTA, whereas separately each Asian country, even Japan, would have difficulty during negotiations with such powerful economies.

Mahathir envisioned Japan as the leader of this grouping. Because of Japan's vast foreign investments in the region and because of its massive financial wealth, he hoped that Tokyo would be able to play a role similar to Germany in the EC. With Japan's extremely prosperous citizens, Japan would also be a key market for Asian goods, hopefully reducing the region's reliance on the European and North American markets.

Mahathir's plan was endorsed by several Asian governments, including Singapore and Thailand within ASEAN.⁶ However, the United States strongly condemned the EAEG as an attempt to cut the United States off from Asia. Japan and South Korea did not endorse the group out of fear of provoking the ire of the United States. Among ASEAN, the strongest opposition to the EAEG came from Indonesia. President Suharto disliked the confrontational tone of the EAEG and was afraid of anything which might jeopardize his country's access to the massive American market. Suharto also felt slighted by the fact that Indonesia was not consulted before Mahathir announced his plan.⁷

In October 1991, at ASEAN's annual meeting of economic ministers, Mahathir agreed to change the EAEG to the EAEC (East Asia Economic Caucus). Although the EAEG was originally envisaged as a trade bloc, Mahathir changed his conception of the group's purpose to that of discussing regional trade issues with an aim to present a common front in international negotiations. The change in name from the EAEG to the EAEC underlined that the group was no longer intended to be a trade bloc. Mahathir hoped that if the group was not seen as a trade bloc, the apprehensions of the US would be assuaged and Japan and South Korea would be able to endorse the idea.

The US continued to object to the plan, however, even after the change to the EAEC. Consequently, Japan and South Korea still demurred from joining the group. Indonesia felt that it was inappropriate for ASEAN to endorse the EAEC. One Indonesian ASEAN official argued that the EAEC "would look like an attempt to drive

⁶Asian Wall Street Journal, January 28, 1992, p. 1

⁷Asian Economic News [Kyodo], Jan. 20, 1992

a wedge between Tokyo and Washington".⁸ In order to provide a framework for the EAEC, the Indonesian government proposed that the group be merged with APEC. Mahathir, however, already upset by having his original proposal changed to the EAEC, was unwilling for it to be further diluted by having it be merged with APEC.⁹

The continued opposition to the EAEC among the major economies in Asia ensures, despite continued lobbying by the Malaysian government, that there is little chance that the agreement will proceed. While it is possible that Mahathir's proposal may have proved to be a sufficient response to the rise of trade blocs in the industrialized world, the ASEAN countries never got a chance to evaluate the efficacy of his plan. The proposal's demise made it incumbent for ASEAN to act on its own in order to guard against the negative repercussions of economic regionalism.

Foreign Investment

The diversion of foreign investment from ASEAN to other regions of the world due to economic regionalism has been the most clearly expressed concern of ASEAN leaders. According to Prime Minister Goh of Singapore, "unless ASEAN can match the other regions in attractiveness both as a base for investments as well as a market for their products, investments by multinational companies are likely to flow away from our part of the world to Europe and NAFTA." Prime Minister Chuan Leekpai of Thailand stated that "the possible diversion of direct foreign investment to emerging economic blocs...is a perpetual reminder that smaller countries have to unite to make themselves attractive to foreign investment."¹⁰

Regional blocs are attractive to foreign investors because it is possible for a multinational corporation (MNC) to set up a single production plant to serve all the countries within the bloc. Manufacturers can then produce a large quantity in their production facilities, thereby gaining the benefits of economies of scale and increasing profits. Currently, high tariff rates within ASEAN make it difficult for MNCs to set up

⁸Asian Economic News, Jan. 24, 1992

⁹Far East Economic Review February 6, p. 10

¹⁰The Nation [Bangkok], January 30, 1992, p. B1

a single production plant to serve all the countries within ASEAN. Consequently, ASEAN countries feared that MNCs would view the EC and NAFTA as far more profitable places to invest, thereby draining potential sources of foreign investment away from ASEAN. Jusuf Wanandi, of the Center for Strategic and International Studies in Jakarta, stated that "if ASEAN wants to compete successfully for trade and investment, it needs to show that ASEAN itself is a big enough market."¹¹

Trade Negotiations

AFTA was also seen as necessary to be able to deal effectively with large economic powers in trade negotiations. During the Uruguay Round of the GATT negotiations, many ASEAN countries felt relegated to the sidelines as major international actors such as the United States and the EC dominated the negotiations. Similarly, ASEAN countries felt disadvantaged when engaging in bilateral negotiations with the EC and the United States. In particular, the actions of the United States in the last few years, under the Super 301 provision of the Omnibus Trade Bill, have occasionally been a major source of irritation for some members of ASEAN.

In order to have a stronger negotiating stance, some of the members of ASEAN have felt that it would be necessary to present their positions collectively, as a group, rather than as individual countries. President Suharto, in his opening statement at the Singapore summit, maintained it is necessary to "enhance intra-ASEAN economic cooperation to ensure that our role and interests are given greater attention." By forming a regional grouping encompassing 330 million people, the members of AFTA feel this will do much to redress the problem of being overlooked or bullied by the major economies in the world. An example of AFTA's unified approach to negotiations is that the group has "agreed to put up a united front to promote exports of certain agricultural goods and negotiate with the group's trading partners on market access amid the escalating protectionism worldwide."¹² Another sign of the increased

¹¹Asian Wall Street Journal, January 24, 1992, p. 1

¹²The Nation, January 25 1992, p. B1

clout of AFTA is that the EC announced that it wished to have regular dialogue meetings between the two blocs.¹³

Reduced International Competitiveness

The members of ASEAN felt that the creation of AFTA was imperative to strengthen, or at least maintain, the region's international competitiveness. They are afraid that the competitiveness of products from the EC and NAFTA will improve as a result of intra-bloc competition. With no barriers to the transfer of goods within these two blocs, companies which used to be protected by tariffs and other trade barriers will now be forced to compete with other companies from within the entire bloc. Consequently, only the most efficient producers in Europe and North America will survive the intra-bloc competition, while inefficient companies will fall by the wayside. Those companies that remain will in turn have a larger market share than they did before, because they will take over the markets of the companies which were forced out due to competition. As a result of having larger market share, the efficiency of these companies will be further enhanced, because they will now be able to produce utilizing economies of scale. AFTA was seen as the only possible way to compete with these improved companies from Europe and North America.

¹³Bernama [Kuala Lumpur], January 25 1992.

Factors Which Make AFTA Likely to Succeed

Product Coverage

ASEAN's previous attempt at increasing intra-regional trade, the Preferential Trading Arrangement (PTA), was unsuccessful because the products that were included in the agreement were either meaningless items that were not traded, or were goods which already faced low tariff rates. Goods included in the PTA accounted for only 5% of ASEAN's intra-regional trade. The most significant factor working in favor of the implementation of AFTA is that the agreement has very broad product coverage. In total, over 38,308 products are currently scheduled for tariff reductions, encompassing 87% of ASEAN's total trade. As table 2 indicates, only 7% of ASEAN's trade, namely services and unprocessed agricultural goods, were permanently excluded from tariff reductions. An additional 3,839 items, accounting for 6% of ASEAN's trade, were temporarily excluded from the agreement. However, this temporary list will be reviewed after eight years, to determine whether these products still warrant exclusion from the agreement.

Significantly, fifteen sectors of goods were selected for accelerated tariff reductions under the CEPT. As Table 3 indicates, the amount of intra-regional trade in these fifteen sectors accounts for 24.7% of ASEAN's total intra-regional trade. Thus, even if AFTA were to go no further, a very large amount of trade will have been liberalized. It was very important to create the perception, both within ASEAN and outside, that the agreement was proceeding forward expeditiously. The sense of the agreement's inevitability could be a powerful incentive for foreign investment and could also increase the political resolve of ASEAN's leaders towards AFTA.

Product coverage was also immeasurably improved as a result of the "6 minus X" provision in the Framework Agreement. In ASEAN's previous attempt at increasing intra-regional trade, the Preferential Tariff Agreement (PTA), decisions about which products to include in the agreement were made by consensus. Consequently, if one country strenuously objected to a certain product being included in the agreement, that one country could normally prevent all the other ASEAN

countries from reaping the benefits of freer trade in that particular product. ASEAN's leaders recognized that using consensus to determine which products were included in the agreement was a severe hindrance to reducing barriers on intra-regional trade. Consequently, under the "Six Minus X" provision, member states can opt out of reducing tariffs on a particular product if they are not yet ready. However, in opting out of reducing tariffs on that product, this will not preclude other countries from lowering their tariffs on this product. The reduction in tariffs will apply to the six countries in ASEAN minus any country or countries who do not wish to open up their markets for that product.

TABLE 2: GOODS PERMANENTLY EXCLUDED FROM AFTA

	IMPORTER					
	Indones.	Malaysia	Philippi.	Singap.	Thailand	ASEAN
Regional Supplier of Imports	1988	1988	1988	1988	1987	
Goods Included in AFTA						
ASEAN	1,211	2,482	770	7,599	1,926	13,987
Non-ASEAN	11,396	12,598	7,174	34,630	10,440	76,238
World	12,607	15,081	7,943	42,228	12,366	90,225
Goods Excluded from AFTA						
ASEAN	93	623	26	205	62	1,010
Non-ASEAN	549	839	762	1,428	544	4,122
World	642	1,462	788	1,633	606	5,131
All Imported Goods						
ASEAN	1,304	3,105	796	7,804	1,988	14,997
Non-ASEAN	11,944	13,437	7,936	36,058	10,984	80,359
World	13,248	16,542	8,731	43,862	12,972	95,356

Source: Calculated using data from United Nations. Commodity Trade Statistics.

The main advantage of the "Six minus X" provision is that it will mitigate the problems caused by different levels of development and competitiveness within ASEAN. The Philippines will likely be the country which will be most hesitant to open its markets, followed by Indonesia. While there is no way of ascertaining whether these two countries will significantly defer the liberalization of their markets, their decision will not affect the speed at which the other four countries, who want to implement AFTA quickly, wish to open their markets.

TABLE 3: IMPORTS OF ACCELERATED CEPT GOODS

	IMPORTER					
	Indonesi	Malaysia	Philip-	Singa-	Thailand	ASEAN
	a		pines	pore		
Regional Supplier of Imports	1988	1988	1988	1988	1987	
ASEAN	476	495	209	2,116	403	3,700
Non-ASEAN	3,437	2,609	1,640	9,041	3,243	19,970
World	3,913	3,105	1,848	11,157	3,647	23,670

Source: Calculated using data from United Nations. Commodity Trade Statistics.

Product coverage was also improved as a result of the decision to only allow for exclusions at the sectoral level.¹⁴ The previous ASEAN attempt at increasing intra-regional trade, the PTA, foundered because exclusions from the agreement were done on a product by product basis. Exclusions done in this way were very easy, as countries could pin-point specific industries for protection. It will be much harder to exclude at the sectoral level, each of which encompasses a large number of similar goods, than to exclude at the specific good level.

¹⁴Straits Times [Singapore], January 29, 1992, p.2

Commitment to Tariff Liberalization

A very important factor working in favor of AFTA is that most of the leaders of ASEAN have committed themselves to tariff liberalization. Considering the fact that most of their economies are based on exports, the ASEAN leaders know that they must remain internationally competitive lest their country's prosperity be threatened. Even in the absence of the rise of economic regionalism, the countries of ASEAN likely would have felt inexorable pressure to lower their tariffs to ensure that their exports remain globally competitive. It is significant that a number of countries were proceeding with liberalization strategies even before AFTA. Former Prime Minister Anand of Thailand pointed out that "most of us have been liberalizing our tariff and import regimes. We are now better equipped than ever before to move towards a higher plane of ASEAN economic cooperation." In June 1991, Indonesia dramatically lowered its tariffs and barriers to foreign investment.¹⁵ The average tariffs on goods imported into Indonesia is now (20%). For the past few years, Malaysia has been lowering its barriers to foreign goods, and now has an average tariff rate of only (9%).¹⁶ Thailand, which before AFTA had the highest tariff levels within ASEAN, announced immediately after the Singapore summit that it would unilaterally reduce tariffs faster than the agreement calls for. Thai tariffs on more than 1,000 ASEAN goods were reduced to 30% on Feb. 16, 1993.¹⁷ Singapore and Brunei do not need to substantially reduce their tariffs to comply with AFTA, since they have de facto free trade already. In fact, at the beginning of 1993, Singapore completely eliminated tariffs on all ASEAN imported products, thereby fulfilling its commitment to AFTA fifteen years ahead of schedule.¹⁸ The Philippines is the clear laggard in terms of tariff reduction. Before AFTA they had the second highest tariff levels within ASEAN, and there is no sign that they wish to engage in dramatic reductions in the near future.

¹⁵ Far East Economic Review, June 13, 1991, pp. 73-4

¹⁶ The Nation, January 22, 1992, ppA1,A2

¹⁷ Business Times [Singapore], January 1, 1993

¹⁸ Straits Times, January 1, 1993, p. 47

With the other countries heading towards liberalization, however, there may be increased pressure for the Philippines to open its markets.

Potential Stumbling Blocks To AFTA

Short Term Political Pain

The most obvious hindrance to AFTA is the fact that its implementation will engender short term political pain. While the vast majority of people in a country benefit by having open markets, the net gain that they derive is small in comparison to the intense pain that is felt by workers who lose their jobs as a result of foreign competition. The countries which will likely be most negatively affected by the opening up of markets are Indonesia and the Philippines, as their domestic industries are more protected and less competitive compared to those in Singapore, Thailand and Malaysia.

Because of the negative short-run repercussions of AFTA, many analysts view political resolve as the key area of concern for the agreement. Sukhumbhand Paribatra, director of Institute of Security and International Studies at Bangkok's Chulalongkorn University, stated that "the real test is later on—whether the substance of the agreements comes through. ASEAN still needs the political will of its leaders to push this ahead."¹⁹ For the moment, the prospects look favorable that the leaders of AFTA will continue to display the necessary political will for the agreement to be fully implemented.

However, it is much more difficult to initiate and support free trade during periods of low economic growth. Whether ASEAN can maintain the spectacular rates of growth that were achieved in the second half of the 1980s is not certain. Should the

¹⁹Asian Wall Street Journal, January 24, 1992, p. 1

region's growth rates be at a reduced rate in the future, then it is likely that the leaders will be more responsive to the protectionist demands of those who will be hurt by AFTA.

Loophole/ Product Exclusion

Growing directly out of the problem caused by short term political pain is the question of product exclusion. Mohammed Ariff correctly asserted that "much will depend on the exemption list, which is antithetical to the whole AFTA concept."²⁰ Under the CEPT, members are allowed to keep tariffs at their current levels on products whose importation causes or threatens to cause "serious injury" to domestic industries. A significant deficiency of the agreement is that there is no definition as to what constitutes "serious injury". In addition, allowing countries to forego tariff reductions on items merely where they fear "serious injury" is also a major problem, since exemptions would be extremely easy to justify. Furthermore, there is no limit to the number of products that countries can unilaterally exclude in this manner. The Malaysian government has supposedly compiled a list of thousands of products that firms in Malaysia wish to be excluded from AFTA. In an extreme reaction, a Filipino commission studying AFTA has recommended that the Manila government reverse the exclusion process, by listing products to be included in AFTA rather than outlining products to be excluded from the agreement.²¹

A key question will be whether countries will be allowed to keep tariffs on products which cause "serious injury" indefinitely, or whether it will be a temporary exclusion which will merely give extra time for readjustment of extremely sensitive industries. Once exclusions have been established, there will be tremendous political pressure for them to be maintained. If ASEAN does not take a very firm stance on the question of exclusions, then the agreement will not progress expeditiously.

²⁰ Far East Economic Review, February 6, p. 10

²¹ Inter Press Service [Manila], July 20, 1992

Long Lead Time

An attempt to mitigate the problems caused by short term political pain has been to stretch the implementation of AFTA over 15 years, to give adequate time for inefficient industries to adjust to increased regional competition. However, the long lead time is a significant problem with the agreement.

The agreement, as proposed by Thailand, was originally supposed to be adopted over ten years. At one point, the Thai government actually broached the idea of a five year adoption period.²² The idea of a ten year adoption period was strongly supported by the Malaysian, Singapore and Brunei governments.²³ Singapore and Brunei were both largely supportive of the concept because they already have low or virtually no tariffs on most goods.

Indonesia, however, raised strong objections to such a rapid pace. Having the largest market of any ASEAN country, and because many of its industries are not as developed as in other ASEAN countries, Indonesia argued that it would need a longer time to adjust to a free trade area. Although Indonesia raised the strongest objection, the Philippines also felt very uncomfortable with the 10 year time frame because its industries are also not as developed as the rest of ASEAN. Leaders of other countries were sensitive to the concerns of Indonesia, and a proposal put forth by Indonesia for a 15 year implementation period was adopted.²⁴

While the 15 year time frame may be beneficial internally within ASEAN, it will likely dilute the impact of AFTA as a means of attracting foreign investment. Former Prime Minister Anand stated that "I initially proposed 10 years because I felt that period would have a stronger impact on both ASEAN based and foreign investors...so that they have confidence in us. Looking back on the past history of ASEAN, we have not succeeded much in terms of economic cooperation. We want the AFTA to change that. But it will take some time before foreign investors can accurately assess the

²² Antara [Jakarta], January 21, 1992.

²³ The Nation, January 25, 1992, p. B1

²⁴ Antara, January 21, 1992.

situation and market potential here."²⁵ If the long lead time causes the agreement to fall short of its foreign investment goals, then support for the agreement itself may become more tenuous among ASEAN's leaders.

As a result of concern over the length of the adoption period, the six foreign ministers of ASEAN agreed in July that AFTA should be achieved earlier than the 15-year time frame.²⁶ The ASEAN Chambers of Commerce have also held discussion on speeding up the implementation of AFTA.²⁷ However, no mechanisms were adopted to achieve that end.

Regional Security Tensions

Within Europe and North America there are no territorial disputes, the member countries do not look askance at each other's military capabilities, and there is little concern about intra-regional security. All the security threats to the countries within NAFTA and the EC lie outside of those economic alliances, rather than within each bloc. In marked contrast, the countries of ASEAN have not yet resolved their intra-regional security concerns. While ASEAN countries are not hostile towards each other, their relationships are certainly not as free of security suspicions as within the EC or NAFTA.

Just before the Singapore summit, Thailand and Malaysia engaged in talks regarding their borders. The problem between the two countries occurred because uniformed Thai soldiers entered into Malaysian territory once in July 1990 and four times in December 1990. The reason for entering into Malaysia was purportedly to stamp out smuggling. After the talks between the two countries, Mahathir released a statement that "Thailand has agreed that it will not resort to provocative acts and will have discussions with Malaysia on any problem relating to territory."²⁸ Mahathir also held discussions with Suharto over borders, specifically over the Sipadan and Ligitan

²⁵The Nation, January 30, 1992, p. B2.

²⁶Straits Times, July 21, 1992

²⁷Straits Times, January 7, 1993, p. 36

²⁸Bernama, January 26, 1992.

Islands that Indonesia claims. Malaysia and Singapore are currently contesting sovereignty over Pedra Branca islands.²⁹ A serious point of dispute within ASEAN is the Spratly islands, an area with potentially rich deposits of oil and gas claimed wholly or in part by Brunei, Malaysia, the Philippines, China, Vietnam, and Taiwan. Discussions over the Spratlys dominated the ASEAN foreign ministers' meeting last July.³⁰ In addition, there are dangers as a result of the different approaches towards Cambodia taken by Thailand and Indonesia. While none of these disputes threatens to lead to hostilities, their presence is an indication of the suspicious attitude that ASEAN's members have towards each other. Significantly, defense budgets within the region are rising at a very rapid pace.

More significantly, even if there are no pressing security problems within ASEAN itself, there most certainly are a number of potential destabilizing disturbances in the Asia Pacific region which would have deleterious effects upon ASEAN. The combined effect of the end of the Cold War, the withdrawal of US forces from the Philippines and the stated intention of the United States to reduce its forces in the region has accentuated fears within Asia that previously latent disputes may flare up again. Some in Asia fear that Tokyo will eventually feel that they need to fill the region's "security vacuum". Still other countries fear not only that Japan might come to have a much larger security role in the region, but in addition that China or India might begin to seek a larger military presence. Other problems in Asia not as related to the withdrawal of US forces include tensions between North and South Korea. The possibility of implosion within China must always be viewed with great caution. Russia, although focused inward for the foreseeable future, may have the capacity to use its vast military resources in Asia and should always be taken into account.

While none of these threats poses an imminent danger to the security of ASEAN, the great uncertainty in Asia's present security environment led many within ASEAN to call on the group to assume a new security role. Despite the seeming need for ASEAN to develop a way of dealing with regional security issues, there is serious disagreement among the group over which direction to proceed. The danger is that

²⁹International Defense Review, August 1992, p.732

³⁰Straits Times, September 9, 1992

the inability of ASEAN to craft a consensus on forging a new security role for itself will result in greater instability in the region, and will make it very difficult for the group to respond to any possible disturbances. ASEAN's past economic success were greatly dependent on the stability of the region, and that the success of AFTA in the future will be dependent upon continued harmony both within ASEAN itself and between the major powers in the region.

Omissions From the Agreement

There are a number of mechanisms and procedures that are crucial to the formation of a free trade area which are not included in the AFTA agreement. The agreement is specific as to the goals of the treaty, but it is often vague or incomplete as to the means to achieve those goals.

A major shortcoming with AFTA is that there is no fixed schedule of tariff reductions. In marked contrast to NAFTA, where countries have a number of targets which they must meet by specific deadlines, ASEAN countries are free to set their own tariff reduction program.³¹ Because the tariff deadlines within AFTA are so far in the future, there is great danger that countries will delay reductions, possibly to the point where it becomes impossible for them to comply with the agreement. The risk that countries will fail to reduce tariffs enough is particularly strong because there is no supra-national authority with binding power. While the ministerial-level Council is responsible for monitoring whether countries are complying with the agreement's terms, it does not have any powers of enforcement. This is in marked contrast to the provisions in NAFTA, where any delays in implementation leads to the setting up of a panel which deals with the problem. According to Prof. Richard Lipsey, AFTAs lack of enforcement means "there would seem to be little to prevent individual ASEAN countries from delaying tariff cuts if they chose to."³²

Another deficiency with AFTA is that there are no provisions for the coordination of external policy. Most notably, the agreement does nothing to establish

³¹Straits Times, January 13, 1993, p. 36

³²Business Times, January 13, 1993, p. 3

a common stance regarding the treatment of foreign investment. As a result, MNCs will set up in those countries that have the most advantageous laws rather than according to the basis of which country would be most valuable from a production standpoint to locate in. Countries will therefore compete against each other in order to attract foreign investment, which will reduce the benefits accrued from MNCs.

In addition, AFTA does not establish common standards on subsidies or government procurement. Consequently, more efficient industries in one country will often be at a comparative disadvantage with less efficient industries in another country which receive substantial governmental assistance. Such policies will cause the distribution of benefits from AFTA to be less equitable, reduce the group's international competitiveness, and cause a drain on public resources in those countries which engage in significant subsidization.

A significant weakness with AFTA is that there is no specific provision designed to reduce non-tariff barriers. As a result, even if countries are successful in reducing regional tariffs, the gains of trade creation may prove elusive if there is an increase in the importance of less formal barriers to trade. Product standards are the most important kind of NTB which AFTA must deal with. Without common health, safety and other standards, then trade flows within ASEAN could be greatly disrupted.

AFTA did establish a 40% level of local content that a product will have to have in order to qualify for tariff reductions. However, the agreement does nothing to ensure that countries use the same procedures in determining what qualifies as local content. There are numerous possible discrepancies, such as whether or not to count managerial labor, which could lead to substantial variation between countries.

The approach to the drafting of AFTA was vastly different from that which is taken by industrialized countries, where the specific details of free trade agreements are worked out in advance of the ratification of the treaty. AFTA is a political document, in that the text of the treaty was rushed in order to coincide with the Singapore summit. Had the countries party to the agreement wanted the treaty to be economically precise, then it would have taken many more months for the text to be negotiated. It is possible that many of the omissions from AFTA were not made out of ignorance, but that the framers of the agreement instead recognized the need for these

provisions but knew that they would be unable to complete these details before the Singapore summit. Many of these procedures, especially the rules of origin, are extremely complicated. So long as these deficiencies are recognized within ASEAN, and are dealt with, then the eventual success of AFTA will not be greatly diminished. If, however, there is a lack of recognition of these shortcomings, or if they are recognized but there does not exist the political will to implement solutions, then AFTA's progress will be severely hampered. The lack of action on these problems in the period since AFTA's inception is not an encouraging sign that they will be adequately dealt with.

Uneven Levels of Development

One of the major obstacles to AFTA is that the countries within ASEAN are at different stages of economic development. Malaysia, Singapore and Thailand have grown rapidly in the last decade, and now have the ability to manufacture a wide range of goods which are very competitive internationally. Brunei has not yet experienced spectacular growth, but does not fear the effects of foreign competition because of its high level of income from oil exports. Indonesia has grown rapidly in the last few years as well, but its goods are not as competitive as in these first three countries. The Philippines, in contrast to the rest of ASEAN, is economically stagnant and its industries are very uncompetitive.

Because of differences in development and competitiveness, there is great disparity within ASEAN on the question of economic liberalization. Malaysia, Singapore, Thailand, and Brunei are all in favor of quick implementation of AFTA. Singapore and Brunei have everything to gain from AFTA, since their markets are already predominantly open. Malaysia is eager for AFTA because its industries are competitive. As Table 4 indicates, Malaysia already sends 24% of its exports to ASEAN countries, a number which it hopes can grow even larger. Next to Singapore, Thailand has probably the most competitive goods within ASEAN, and therefore feels that it has nothing to fear and much to gain as a result of lower tariffs within ASEAN.

TABLE 4: Percentage Distribution of Exports of ASEAN Countries
by Exporter and Importer

EXPORTER

	Indonesia	Malaysia	Philip- pines	Singapore	Thailand	ASEAN
IMPORTER	1988	1988	1988	1988	1987	
Brunei		0.3%	0.0%	0.9%	0.1%	0.5%
Indonesia		1.3%	0.3%	3.8%	0.5%	1.9%
Malaysia	1.0%		1.3%	12.2%	3.0%	5.7%
Philippines	0.4%	1.5%		1.2%	0.5%	0.9%
Singapore	8.6%	19.3%	2.3%		8.0%	6.6%
Thailand	0.8%	2.0%	1.4%	4.9%		2.7%
ASEAN Total	10.8%	24.4%	5.3%	22.9%	12.1%	18.3%

Source: Author's calculations using data from United Nations. Commodity Trade Statistics.

In contrast to these first four countries, Indonesia is fearful of AFTA, and was the main force in lengthening the implementation of the agreement from 10 to 15 years. Indonesia, with by far the largest market in the group, was afraid that it would be deluged by imports from other ASEAN countries which were more economically advanced. Indonesia's recent economic growth has been based on exports, but not to other countries within ASEAN. Indonesia sends only 10.8% of its exports to other ASEAN countries, which is the second lowest percentage in the group. As a result, Indonesia feels that they have much to lose by AFTA, and pushed for the adoption of the clause which allows countries to stop tariff liberalization of products whose importation causes "serious injury" to domestic industries. Still, the Indonesian government recognizes that tariff liberalization will be beneficial in the long run, and President Suharto has strongly endorsed AFTA.

The Philippines has even greater concerns about AFTA than Indonesia. The Filipino economy is by far the weakest in the group, and its goods are the least competitive. Protected behind very high tariffs, many Filipino industries have become very bloated. The Philippines exports only 5.3% of its exports to ASEAN countries, by far the lowest percentage of any ASEAN country. Like Indonesia, it fears that its inefficient domestic industries will be overwhelmed by foreign competition. Because its politics are far less stable than in Indonesia, it is likely that the Filipino government will respond to the political pressure from industries which will suffer as a result of lower tariffs. Consequently, the Philippines will probably be the country which exerts the most braking power on AFTA.

Conclusion

AFTA was formed as a reaction to a world economic environment that was completely different from that which existed in the past. Previously, when the world trading system was based around the promotion of freer, multi-lateral trade through the GATT, trade blocs were evaluated according to a totally different standard than they are today. According to the old criteria for evaluating the efficacy of a trade bloc, AFTA would appear unlikely to succeed. The fact that ASEAN has largely competitive rather than complementary economies, that these economies are at different levels of development, that regional economic integration is quite low, and that there are unresolved regional security and political tensions would lead one to conclude that an ASEAN trade pact would not be appropriate. It was because of these factors that, in 1987, ASEAN in fact rejected the idea of forming a free trade pact.

Since 1987, however, the economic environment outside of ASEAN has changed immensely. In 1987, the goal of European economic integration still seemed unattainable, there was not yet a free trade agreement between the United States and Canada, US-Mexico free-trade was not even a policy proposal, and GATT's foundation seemed very solid. At this time, therefore, there was no external justification for the

creation of an ASEAN free trade pact. With the dramatic transformation in emphasis from multi-lateralism to economic regionalism, however, a powerful external rationale for an ASEAN free trade pact was created. ASEAN is perhaps more threatened than any other region in the world by the creation of trade blocs in Europe and North America and by the breakdown of GATT negotiations.

AFTA became the means by which the members of ASEAN could promote their own national interests. The need of countries to protect their strategies of export-led growth outweighed the original resistance to the agreement expressed in 1987. The factors which precluded an agreement in 1987, however, still exist today and will be formidable obstacles to the implementation of AFTA. But these factors are currently regarded within ASEAN as being less threatening than the prospect of not responding to the EC, NAFTA, and the vitiation of GATT.

There is no way of knowing whether the obstacles that precluded a trade pact in 1987 will continue to be less important than the need to respond to economic regionalism. For the foreseeable future, the assertive public stands made by ASEAN's leaders in favor of the agreement as being crucial to the continued prosperity of ASEAN will continue to belie the negative political and economic prospects of AFTA's implementation. Now that the process of tariff liberalization has begun, enough momentum may have been created that the agreement will move forward. However, it appears that ASEAN is still assessing the international environment in order to gauge whether or not AFTA is truly necessary. For the moment, ASEAN's exports have still not been negatively affected by economic regionalism. Because the agreement's implementation period is so extended and many of the difficult political decisions have been delayed into the future, it is evident that AFTA was expressly set up as an insurance policy against a further worsening of the global trade environment. If the world economic environment continues to deteriorate, then the group will be in a position to move forward. However, should the global economic environment become less threatening, either through the re-invigoration of GATT or if the regional trade blocs in North America and Europe prove to not be as trade diverting as they are feared to be, then there will be less impetus to proceed with AFTA.

DISTRIBUTION LIST

	No. of Copies
1. Dudley Knox Library Naval Postgraduate School Monterey, CA 93943-5100	2
2. Research Office Naval Postgraduate School Monterey, CA 93943-5100	2
3. Defense Technical Information Center Cameron Station Alexandria, VA 22304-6145	2
4. Thomas Bruneau Chairman Department of National Security Affairs Naval Postgraduate School Monterey, CA 93943	1
5. Claude Buss Senior Lecturer Department of National Security Affairs Naval Postgraduate School Monterey, CA 93943	1
6. Stephen Brooks Department of National Security Affairs Naval Postgraduate School Monterey, CA 93943	10
7. East/Asia Pacific Affairs Plan and Policy Branch Pentagon, Room 4E475 Office of the Chief of Naval Operations Washington, DC 20350	1

- | | | |
|-----|---|---|
| 8. | Office of the Secretary of Defense
Director, East Asia and Pacific Region
The Pentagon
Washington, D.C. 20301-1155 | 1 |
| 9. | Chief, Pacific East Asia Division
AF XOXXP, Pentagon Room 4D1034
Office of the Air Force Chief of Staff
Washington, D.C. 20301 | 1 |
| 10. | Far East/South Asia Division
OJC5-JG Room 2E973
Office of the Joint Chiefs of Staff
Washington, D.C. 20301 | 1 |
| 11. | CINCPAC
Commander in Chief Pacific
Honolulu, Hawaii 96861-5025 | 1 |
| 12. | Far East Regional Desk
DAMO-SSM Room 3B545
Office of the Army Chief of Staff
Washington, D.C. 20310 | 1 |
| 13. | Subcommittee on Asian and Pacific Affairs
U.S. House of Representatives
707 O'Neill Office Building
Washington, D.C. 20515 | 1 |
| 14. | Subcommittee on East Asian and Pacific Affairs
U.S. Senate Foreign Relations Committee
4446 Dirksen Building
Washington, D.C. 20510-6225 | 1 |
| 15. | Congressional Research Service
CRS/FAND, Room LM-315
Library of Congress
Washington, DC 20540 | 2 |
| 16. | Director, Net Assessment
OSD/NA
Office of the Secretary of Defense
Washington, D.C. 20501 | 1 |

- | | | |
|-----|---|---|
| 17. | Center for Naval Analyses
4401 Ford Avenue
Alexandria, VA 22302 | 1 |
| 18. | Office of the Secretary of the Navy
Attn. Naval Historian
The Pentagon
Washington, D.C. 20350 | 1 |
| 19. | Library
United States Naval Academy
Annapolis, MD 21402 | 1 |
| 20. | Library
United States Military Academy
West Point, NY 10996 | 1 |
| 21. | Subcommittee on International Economic Policy and Trade
U.S. Senate Foreign Relations Committee
Washington, D.C. 20510-6225 | 1 |
| 22. | David Brown
Director for Regional Affairs
State Department, Room 5313
2201 C ST. NW
Washington, D.C. 20320 | 1 |

DUDLEY KNOX LIBRARY



3 2768 00327803 7